Islamic Microfinance As a Tool of Financial Inclusion in Bangladesh

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Abstract

Though Bangladesh has achieved worldwide recognition as a star performer in interest based conventional microfinance programs, she is lagging behind exploring full potentials of Islamic microfinance to promote financial inclusion among unbanked people aiming at poverty and inequality reduction. The experience of poverty programs of NGOs during the last three decades reveals that they have, in general, been successful in serving the moderate poor but failed in reaching the extreme poor mainly due to higher rate of interest and operational cost, lack of customized products and reluctance of religious people to participate in interest based programs. Given this, the present paper focuses on concepts and models of Islamic microfinance and its effectiveness as a tool of financial inclusion in Bangladesh. The paper suggests necessary policy options for combating challenges in order to build a vibrant Islamic microfinance market to cater the demands of all categories of poor, extreme poor in particular.

Key Words: *Islamic micro finance, financial inclusion, Poverty alleviation, Bangladesh*

JEL Classification number: *G21, I32, L3, O16, Z12*

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1. Introduction

Bangladesh has achieved worldwide recognition as a star performer in interest based conventional microfinance programs initiated by Grameen Bank, a successful noble peace prize winning specialized financial institution. A large number of Microfinance Institutions (MFIs) have emerged in Bangladesh to provide collateral free credit to the poor inspired by the apparent success of Grameen Bank and following failures of formal financial institution in reaching the poor. Currently, Bangladesh microfinance industry offers financial services among nearly 37.04 million poor people; more than 90 percent of them are women. A number of empirical studies reveal that micro finance has positive impacts on the living standard of the poor (Zaman, H, 2004; Khandker, S. R., 2005, Osmani, S.R., 2012 and Khandker, Shahidur R., et. al.,. 2015). But a large portion of poor people, hardcore poor in particular are yet out of micro finance's network. The experience of the last few decades suggests that while the poverty programs of NGOs including microcredit programs have, in general, been successful in reaching the moderate poor, the poorest of the poor are more often inadequately served or completely bypassed by such programs (Emran, M. S., Robano, V., & Smith, S. C., 2014). The failures of the conventional microfinance industry may be attributed mainly to higher rate of interest and operational cost and reluctance of religious people to participate in interest based programs. Against this backdrop, Islamic microfinance based on Zakat and other unique funding models can emerge as an effective financial inclusion tool in fighting all types of poverty in Bangladesh. Despite being a Muslim majority country and experiencing robust growth of Islamic banking, Bangladesh is lagging behind in promoting Islamic microfinance. The interest based conventional microfinance industry belongs to 95 percent market share of the microfinance industry while Islamic microfinance industry accounts for only 5 percent share of the market in Bangladesh. Given this, the present paper would examine the current status, potentials and effectiveness of Islamic microfinance as a tool of financial inclusion to combat poverty and inequality in Bangladesh.

A good number of empirical literatures exhibit that financial development and improved access to finance in a country, referred to as financial inclusion contributes to growth by allowing the efficient intermediation of resources among savers and investors (Honohan, 2004; Levine, 2005; Beck and de la Torre, 2006; Beck, Demirgüç-Kunt, and Levine, 2004 & 2007; World Bank, 2007). Researchers have also focused on the link between financial development, reduced income inequality and poverty alleviation (Hannig A. and Jansen S., 2010). Although financial inclusion has improved in Bangladesh, a large number of populations, hardcore poor in particular have yet remained financially excluded and as

a result, they have fallen into persistent poverty trap. Despite rapid fall in poverty level following sustained growth in GDP, and robust inflows of foreign remittances, currently 24.8 percent out of total 160 million people live below poverty line in 2015 with 12.9 percent hardcore poor (World Bank, 2015). If we consider marginally non-poor people, the number of poor and vulnerable people will be more than one-third of the population. Income inequality is also acute in Bangladesh with a Gini coefficient of 0.46 at the national level in 2010 (Osmani, S. R., 2011). The trickle down effects of GDP growth and massive expansion of conventional microfinance and other poverty reduction tools as social safety nets have not been able to lift out all poor people out of the poverty cycle. Given this, unique models of Islamic micro finance (IMF) can promote the financial inclusion among poor people for reducing poverty and inequality in Bangladesh by using distributive and risk sharing mechanisms which are absent in traditional microfinance models.

The paper has been organized into seventh chapters. Following introduction, the second chapter contains objectives and research methodology of the paper; the third chapter deals with review of literature; the fourth chapter explains concepts, models and country experiences of Islamic microfinance; the fifth chapter examines effectiveness of Islamic microfinance as a tool of financial inclusion; the sixth chapter assesses current status and potentials of Islamic microfinance in Bangladesh and finally, the seventh chapter points out challenges facing by Islamic microfinance, contains policy options and conclusions.

2. Objectives and Methodology

2.1 Objectives

The objectives of the paper are twofold: first, to review current status, necessity, potentials and effectiveness of Islamic micro finance as a tool of financial inclusion for alleviation of poverty in Bangladesh, and second, to put forward policy options to build a strong Islamic micro finance market in Bangladesh. The broad objectives include:

- *To shed light on concepts and models of Islamic microfinance*
- *To examine effectiveness of Islamic microfinance as a tool of financial Inclusion*
- *To assess current status and potentials of Islamic Microfinance in Bangladesh*
- *To examine challenges faced by Islamic microfinance in Bangladesh*
- *To provide policy options for smooth growth of Islamic micro finance for reducing poverty and inequality aiming at building a caring and egalitarian society.*

2.2 Methodology

The required information/data has been collected from secondary sources to derive the objectives of the study. The secondary source contains scholarly articles, reports of regulatory authority, research organizations, donor and Government agencies on Islamic microfinance. Descriptive analytical method has been used in the paper.

3. Literature Review

Islamic banking has grown significantly both in Muslim majority and minority countries across the globe during the last four decade. However, Islamic microfinance did not expand to the expected level. Similarly, research works on Islamic microfinance, financial inclusion and poverty issues are not available in greater number. As Islamic microfinance is evolving gradually, most researches on Islamic microfinance are theoretical and academic in nature.

Ahmed, H., (2002) provides the theoretical basis, operational framework, and empirical support for the establishment of Islamic MFIs. The author presents an Islamic alternative after critically evaluating the conventional MFIs. The theoretical part of the paper shows that there is a great potentiality of Islamic MFIs that can cater for the needs of the poor. Islamic MFIs have some inherent characteristics that can mitigate some of the problems faced by conventional MFIs. Empirical evidence from three Islamic MFIs operating in Bangladesh, in general, supports some of the theoretical assertions. Ahmed, H., (2007) studies the economics of microfinancing and discusses the sustainability and operational issues of a waqf-based MFI in details.

Wilson, R., (2007) explores models, instruments and structures of Shariah compliant microfinance. Although the paper is largely conceptual and theoretical, it mentions a number of existing Shariah compliant microfinance schemes Indonesia, Malaysia, Yemen and Syria. The paper suggests that Shariah compliant microfinance is best provided by non-banking institutions, which in the case of the wakalah model, may have links to the waqf and zakat authorities. With murabaha profit sharing microfinance, there is scope for commercial undertakings, but arguably specialized finance companies rather than banks, even Islamic banks, may be more appropriate institutions to get involved.

Ahmad, A. U. F., & Ahmad, A. R. (2008) explains the key role of Islamic Microfinance Services Providers (IMSPs) in Australia in fulfilling the microfinance needs of Muslim community. The study concludes that IMSPs in Australia can proliferate in microfinance if they gradually advance towards undertaking more creative microfinance techniques

to suit the financial needs of their clientele to facilitate their desired contribution in microfinance.

Obaidullah, M. (2008a) develops models of inclusive microfinance for Muslim societies and proposes a model for linking social safety nets to microfinance in view of the limitation of the latter to reach out to the poorest of the poor and the destitute through the Islamic institutions of zakah and awqaf. Obaidullah, M. (2008b) is a monogram explaining the building blocks of a microfinance program targeted at Islamic societies. For poverty alleviation efforts to succeed in these societies, there is need for an appropriate model that is rooted in Islam and conforms to beliefs, cultures of the Muslim clients. The monogram focuses on the mechanisms, models, tools and instruments of the Islamic approach as prescribed by the glorious Shariah.

Asyraf Wajdi Dusuki (2008) provides an extensive review of microfinance with the objective of building a case for Islamic banking to participate in a microfinance initiative. The paper argues that microfinance requires innovative approaches beyond the traditional financial intermediary role. Among others, building human capacity through social intermediation and designing group-based lending programmes are proven to be among the effective tools to reduce transaction costs and lower exposure to numerous financial risks in relation to providing credit to the rural poor. This paper suggests that Islamic banks can actually practice microfinance without undermining their institutional viability, competitiveness and sustainability.

Obaidullah, M., & Khan, T. (2008) presents the "best practices" models of microfinance and the consensus principles of the microfinance industry. It highlights the Islamic approach to poverty alleviation through microfinance and underscores the need for a dual approach: a zakah and awqaf-based charity program for the destitute, disabled and "unbankable" and a micro-finance program of wealth creation. The authors opined that the Islamic approach to poverty alleviation is more inclusive than the conventional one.

Rahman, M M., (2010) assesses the impacts of Islamic microfinance offered under Rural Development Scheme (RDS) of Islami Bank Bangladesh Limited (IBBL), the first Islami Bank in Bangladesh and South Asia. Findings show that household income, productivity of crops and livestock, expenditure, and employment had increased significantly due to the impact of invested money. Results also reveal that clients' socio-economic factors like age, number of family members in farming, total land size and clients'ethics and morals had a positive and significant influences on household income.

Ashraf, M. A. (2010) examines impact of microfinance on browsers of 3 MFIs based on exploratory survey in Bangladesh. The author also explores the possibility of establishing Islamic microfinance Institutions (IMFI) as an alternative to conventional microfinance Institutions (MFI). The findings of the paper show that overall impact of microfinance on borrowers is not satisfactory. It also opined that Islamic financing instruments can be effectively integrated into microfinance programs for alleviating poverty.

UNDP (2012) examines efficacy of Islamic microfinance program under Rural Development Scheme (RDS) introduced by Islami Bank Bangladesh Limited. Results reveal that Islamic microfinance has a positive role in poverty alleviation with huge untapped potential as an effective socio-economic development tool. The report mentions that millions of poor people can be lifted out of poverty by scaling up Islamic micro financing in Muslim majority countries. The report opines that countries wishing to emulate the RDS programme with the assistance of the private sector must place strong emphasis on capacity building at all levels in order to realize the potential of Islamic microfinance.

Ashraf, A and Hassan, M. K (2013) analyses reasons for failures of conventional microfinance in poverty alleviation. The authors provide an Islamic microfinance model combining Islamic microfinance with two traditional Islamic tools of poverty alleviation such as Zakat and Awqaf in an institutional setup. The proposed model would be financially viable and sustainable in the long run. If implemented, this model will contribute to poverty alleviation by combining all three approaches: positive measures (like increasing income growth through development of micro business for the poor), preventive measures (through ensuring functional redistribution among factors of productions), and corrective measures (engaging Zakat and Awqaf).

Mollah, S., & Uddin, M. H. (2013) argues that Islamic Microfinance can adopt microfinance best practices without compromising Shariah compliance. The authors mention that group financing as practiced in conventional microcredit of Grameen bank should be the key criterion for Islamic microfinance. The authors propose a three staged integrated model to alleviate poverty in an effective manner. The first stage is designed for the poorest (Zakat based), the second stage for the poor graduated from first stage (qard hasana based) and the third stage for the poor graduated from second stage (mudaraba PLS based).

Hassanain, K.M., (2015) examines three models namely Waqf-Based Islamic Microfinance Institutions, a Model of Zakah and Awqaf-based MF Organizations and an

Integrated Awqaf and Zakah Model of Microfinance. Both Zakah and Waqf mechanisms are considered for Islamic microfinance not only because of their frameworks that are in accordance to the Shariah but they are the original concepts provided in Islam that serve the poor. In tandem with the doctrine of microfinance, Zakah and Waqf are seen as tools best suited to assist the poor who require financing and ultimately could be effective for poverty reduction. The paper derives recommendation for integrating microfinance models into the overall economic policy.

Haneef, M. A., et al., (2015) attempts to develop an integrated waqf-based Islamic microfinance (IsMF) model (IWIMM) for poverty reduction in Bangladesh. The authors show that there are significant relationships between IsMF and takaful, waqf resources and human resource development, takaful and human resource development, IsMF and human resource development and, waqf resources and project financing. The results reveal that poverty alleviation is possible through the integration of these constructs in Bangladesh. The authors suggest that further studies need to be conducted in other OIC member countries to adopt the model in line with practical and regulatory environment of those countries.

Zulkhibri, M., (2015) examines the inter-linkage between financial inclusion and the Islamic financial services industry in Muslim countries using qualitative analysis and case study. The finding shows that despite financial sector growth most Muslim countries lag behind other emerging economies in financial inclusion, with only 27 percent adults having bank accounts. The author identifies cost, distance, documentation, trust and religious beliefs as important obstacles for financial inclusion. The study also mentions that the outreach of Islamic microfinance is very limited, small by international standards, and of a limited coverage, which accounts for a small fraction of microfinance supply, about 0.5 percent of global microfinance and lack of cost-efficient service model. However, the study suggests that Islamic distributive instruments such as zakah, sadaqa, awqaf, and qard-alhassan can play a role in bringing more than 40 million financially excluded religious populations into the formal financial system. The paper proposes policy recommendations to address the demand and the supply side dimensions for improving financial inclusion via strengthening and widening Islamic financial services and products.

Pg Md Salleh, A. M. H. A. (2015) aims to identify how zakat institutions in Brunei can facilitate financial inclusion into their practices, assist to fulfill the saving motives of zakat recipients and create financial products/solutions for the poor and destitute. The paper highlights the need for bank accounts and credit facilities that meet the

needs of welfare recipients to fulfill their daily needs, as well as saving for children/ grandchildren's education, and for welfare recipients who save. The findings show that zakat and other social institutions in Islam can adapt to contemporary challenges in personal finance, notably in facilitating financial inclusion and understanding saving motives of recipients.

Mahmood, H. Z., Fatima, M., Khan, M., and Qamar, M. A. (2015) seek to to observe the impacts of Islamic Microfinance (IMF) on the assets and poverty status of the households who borrowed from three pioneering organizations i.e. Akhuwat Foundation, Farz Foundation and NAYMAT based in Lahore, Punjab, Pakistan. The findings reveal positive impacts of Islamic microfinance on the lives of the poor. A significant increase in incomes and expenditures was observed in case of clients of all of the institutions. Moreover, similar increase was experienced in case of assets holdings in post funding scenario of the organizations to their clients.

4. Concepts, Models and Country Experiences of Islamic Microfinance

4.1 Concept and Principles of Islamic Microfinance

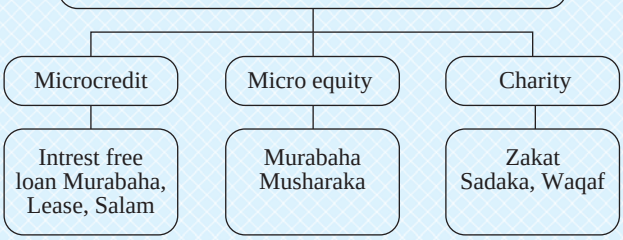
In common parlance, microfinance means small financial services offered mainly by NGOs/MFIs/cooperatives among poor people for accelerating income generating activities toward poverty alleviation and social development. The key financial services delivered by microfinance institutions include microcredit, micro savings, micro insurance, remittances and other financial products in which credit plays dominating role.

Islamic micro finance refers to financial services delivered among low income/destitute people based on Islamic Shariah. The conventional microfinance is operated based on interest which is prohibited in Islam. Islamic microfinance is offered as an alternative among religious poor people for poverty alleviation by employing both charity and profit based unique models. Like Islamic banking, Islamic microfinance operates its programs following the principles of Islamic Shariah which includes prohibition of interest, risk sharing, and avoidance of gharar or ambiguity and ensuring falah (welfare) for all member of the society.

According to GIFR (2012) as reported by Usman, A. S., & Tasmin, R. (2016) the Islamic micro-finance products can be divided into three classes such as micro-credit, micro-equity and charity. The micro-credit entails the usage of business asset based on loan or lease that eases the lack of capital in the face of a business opportunity.

Micro-equity establishes a business relationship between provider of capital and the entrepreneur who manages the business. Under micro-equity, factors of production are brought together while profit/loss is shared in line with agreed upon formulae. The charity type of Islamic micro-finance serves as a source of additional empowerment in the form of safety nets and for sustainability motives.

Figure 1: Islamic Microfinance Structures



Source: Usman, A. S., & Tasmin, R. (2016)

4.2 Differences between Conventional and Islamic Microfinance:

Both conventional and Islamic microfinance have common features such as serving the poor, social mission of poverty alleviation and employment generation by offering credit, savings, training and other social services, and non-profit motives. However, both systems have differences in target, pricing of products and operational models (Table 4.1).

Table 4. 1: Differences between Conventional and Islamic Microfinance

Particulars	Conventional MF	Islamic MF
Target Group	Women	Family
Objective of Targeting	Empowerment of Women	Ease of Availability
Pricing of financial products	Interest based	Profit-loss, mark-up and rental based
Sources of Fund	Foreign donors, multilateral and national agencies, government, central banks, savings of clients	Religious institutions, Islamic charitable sources, savings of clients, foreign donors, national agencies, private sector
Serving hardcore poor	Bypassing	Successful in serving
Funds transfer	Cash	Goods
Liability of the Loan (Which given to Women)	Recipient	Recipient and Spouse
Work Incentive of Employees	Monetary	Monetary and Religious
Dealing with Default	Group/Center pressure and threat	Group/Center/Spouse Guarantee, and Islamic Ethic

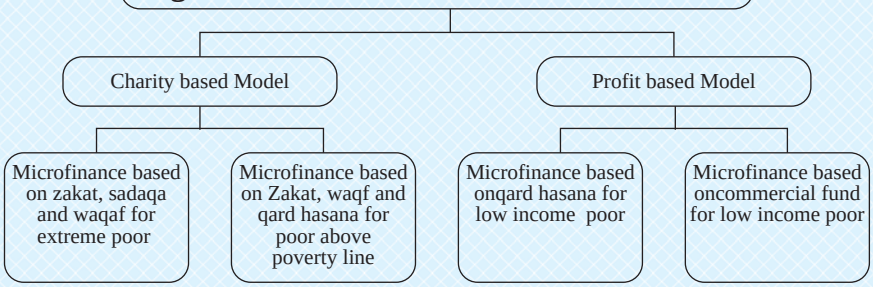
Source: Adopted from Ahmed H (2002)

4.3 Islamic Microfinance: Models, Funding and Financing Modes

Islamic Microfinance has unique, innovative and inclusive features in serving all categories of poor ranging from hardcore to moderate poor.

Models: Islamic microfinance has inclusive models to incorporate moderate poor and extreme poor. Islamic microfinance models can be divided into charity and profit based model as shown in Figure 4.2. Charity based model based on zakat, sadaqa, waqaf and qard hasana serves for extreme poor and marginal poor just above poverty line. Profit based model based on qard hasana and commercial funds serves for low income poor.

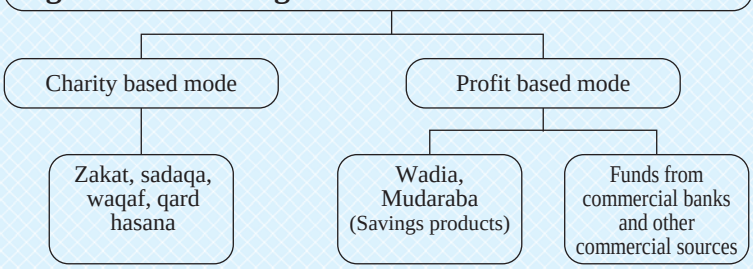
Figure 4.2: Models of Islamic Microfinance



Source: Obaidullah, M. (2008) and Iqbal Z. (2015) with some modifications

Funding Modes: Islamic microfinance has charity and profit based funding modes as shown in Figure 4.3. The funding modes of Islamic microfinance ensures that all categories of poor can be served- charity based funding for extreme poor and marginal poor just above poverty line and profit based mode for low income poor.

Figure 4.3: Funding Modes of Islamic Micro Finance



Source: Compiled by the author

Zakat- It is the third of the five basic pillars of Islamic faith. Zakat is a compulsory levy imposed on the Muslims so as to transfer a portion of wealth from the rich members

of the Muslim society to distribute the same among the poor. It is a part and parcel of Islamic society as the right of poor has been declared in the wealth of the rich. Thus, zakat works as a tool for the distribution of wealth and a sustainable source of funding of charity based microfinance which helps the poor to meet their basic needs.

Sadaqa-It means voluntarily donations made by Muslims to remove hardship of the poor people. Islam considers it the collective duty of Muslim society to take care of the poor. Numerous verses of the holy Quran and many sayings of the great Prophet Muhammad (SM) urge Muslims to give charity. Islamic teachings encourage the rich to contribute toward the welfare of the poor segments of society to seek the blessings of Allah. Funds collected as sadaqa may be a viable source of funding of charity based microfinance.

Waqf- The word waqf in Islamic legal terminology is defined as protecting an asset in order to refrain the usage, and will be utilized and benefited for the purpose of charity. Kahf (2003) defines five different types of Waqf: (a) Religious Waqf-spread of religion, (b) Philanthropic Waqf-welfare of the general public, (c) Family Waqf-welfare of the family members, (d) Waqf of Usufruct-only usufruct of the property is used as Waqf, and (e) Financial Waqf-only the income generated can be used for Waqf purposes. Income from waqf may be a viable source of funding of charity based microfinance.

Wadia- These deposits/savings accounts may be used to encourage the microfinance client to save even smaller amounts as they are allowed to withdraw whenever they want, and there is no risk of loss.

Mudaraba- The microfinance clients can open mudaraba savings account with MFI to save surplus funds. Under this mode, the client is exposed to investment risks and shares the profit with the institution on a pre-determined ratio.

Financing Modes: Islamic microfinance uses different financing modes to tackle different levels of poverty as shown in Figure 4.4.

Figure 4.4: Financing Modes of Islamic Micro Finance

Source: Adopted from Iqbal, Z., & Mirakhor, A. (2011) and other sources

Mudaraba: Mudaraba is a shared venture between labour and capital. Here MFI provides with entire capital and the investment client conducts the business. The MFI, provider of capital, is called Sahib-Al-Maal and the client is called Mudarib. The profit is to be distributed between the MFI and the investment client at a predetermined ratio while the bank has to bear the entire loss, if any.

Musharaka: Under Musharaka, every partner has to provide more or less equity funds in this partnership business. Both the MFI and the investment client reserve the right to share in the management of the business. But the MFI may opt to permit the investment client to operate the whole business. In practice, the investment client normally conducts the business. The profit is divided between the MFI and the investment client at a predetermined ratio. Loss, if any, is to be borne by the MFI and the investment client according to capital ratio.

Murabaha: Contractual buying and selling at a mark-up profit is called Murabaha. In this case, the client requests the MFI to purchase certain goods for him. The MFI purchases the goods as per specification and requirement of the client. The client receives the goods on payment of the price which includes mark-up profit as per contract. Under this mode of investment, the purchase/ cost price and profit are to be disclosed separately.

Muajjal : "Bai-Muajjal" means sale for which payment is made at a future fixed date or within a fixed period. In short, it is a sale on credit. It is a contract between a buyer and a seller under which the seller sells certain specific goods (permissible under Shariah and Law of the Country) to the buyer at an agreed fixed price payable at a certain fixed future date in lump sum or within a fixed period by fixed installments.

Salam: Salam means advance purchase. It is a mode of business mainly used in agriculture under which the buyer pays the price of the goods in advance on the condition that the goods would be supplied / delivered at a particular future time. The seller supplies the goods within the fixed time.

Istisna: Istisna is a contract executed between a buyer and a seller under which the seller pledges to manufacture and supply certain goods according to specification of the buyer. An Istisna agreement is executed when a manufacturer or a factory owner accepts a proposal placed to him by a person or an Institution to produce/manufacture certain goods for the latter at a certain negotiated price. An order placed for manufacturing or producing those goods which under prevailing customs and practice are produced or manufactured will be treated as Istisna contract.

Ijara (Lease): The mode under which any asset owned by the bank, by creation, acquirement / or building-up is rented out is called Ijara or leasing. In this mode, the leasee pays the Bank rents at a determined rate for using the assets/properties and returns the same to the Bank at the expiry of the agreement. The Bank retains absolute ownership of the assets/properties in such a case. However, at the end of the leased period, the asset may be sold to the client at an agreed price.

Quard Hassan (Benevolent loan): This is a benevolent loan that obliges a borrower to repay the lender the principal amount borrowed on maturity. The borrower, however, has the discretion to reward the lender for his loan by paying any amount over and above the amount of the principal provided there will be no reference (explicit or implicit) in this regard.

Takaful: Takaful, a risk management tool is one of the most important products for clients of MFI institutions who are generally unable to plan or save for unexpected or uncertain events in the future. Takaful, ideally, is a non-profit mode where all the participants provide joint guarantees. Under takaful, a joint fund is formed by contributions of each participant and the fund money is then used to support/ help any member of the contributing fund in difficult times like death, sickness, crop or business loss, etc.

4.4 Country Experience of Islamic microfinance

Islamic microfinance based on risk sharing and charity model has emerged as an effective tool in enhancing financial inclusion among about 700 million poor people living in Muslim countries (World Bank, 2014) due to using interest rate as pricing mechanism by conventional microfinance programs and its other constraints such as high rate of interest, lack of sustainable fund and mission drift. The Global Islamic Finance Report, 2014 mentions that Islamic microfinance is growing gradually in the developing economies of South Asia (Pakistan, Bangladesh), South East Asia (Malaysia, Indonesia) and Sub Shaharan Africa (Sudan). Among the front runners are Islami Bank Bangladesh, Akhuwat in Pakistan, Amanah Ikhtiar Malaysia and Agricultural Bank of Sudan. Islamic microfinance institutions can be found in more than 15 countries across Asia (Afghanistan, Indonesia, Bangladesh, Pakistan, and Malaysia), Middle East and North Africa (Bahrain, Egypt, Iraq, Jordan, Lebanon, Palestine, Sudan, and Yemen), Central Asia (Kazakhstan, Kyrgyzstan) and Eastern Europe (Bosnia Herzegovina, Kosovo).

While the Islamic microfinance has great potentials as an effective tool for poverty reduction, its overall supply is small relatively to the conventional microfinance sector. Indeed, Islamic microfinance presents less than 1% of global microfinance programs. The estimated total number of poor clients using Shariah-compliant products is about 1.28 million, while there are only 255 providers of Shariah-compatible microfinance products and services worldwide. About 64 % of these providers are concentrated in East Asia and Pacific and 28 % concentrated in the Middle East and North Africa (GIFR, 2014).

5. Effectiveness of Islamic Microfinance as a Tool of Financial Inclusion

5.1 Concept of financial inclusion

Sarma (2008) defines financial inclusion as a process that ensures the ease of access, availability, and usage of financial services of all members of society. Financial inclusion is also viewed as the delivery of financial services to low-income segments of society at affordable cost (Mohieldin, M., Iqbal, Z., Rostom, A.M. and Fu, X., 2011). Amidžić, Massara, and Mialou (2014) stated that financial inclusion is an economic state where individuals and firms are not denied access to basic financial services. The concept of financial inclusion is based on several dimensions, including accessibility, availability, and usage. Amidžić, Massara, and Mialou (2014) constructed a financial inclusion indicator as a composite indicator of variables pertaining to its dimensions, outreach (geographic and demographic penetration), usage (deposit and lending), and quality (disclosure requirement, dispute resolution, and cost of usage.

Since the early 2000s many governments and central banks in developing nations have adopted financial inclusion as a significant common policy agenda. Iqbal, Z. and Mirakhor, A. (2012) mentions that during the past decade, the concept of financial inclusion has evolved into four dimensions: easy access to finance for all households and enterprises, sound institutions guided by prudential regulation and supervision, financial and institutional sustainability of financial institutions, and competition between service providers to bring alternatives to customers. Traditionally, the financial inclusion of an economy is measured by the proportion of population covered by commercial bank branches and ATMs, sizes of deposits and loans made by low income households and SMEs. However, availability of financial services may not equal financial inclusion, because people may voluntarily exclude themselves from the financial services for religious or cultural reasons, even though they do have access and can afford the services (Beck and Demirguc-Kunt 2008).

5.2 Significance of financial inclusion

Financial inclusion has emerged as a powerful tool for promoting inclusive economic growth, eradicating poverty and reducing inequality in the emerging and developing country. A growing body of research unveils that financial inclusion has significant benefits for both firms and individuals (Ayyagari, M., & Beck, T., 2015). Citing different works of famous researchers, Ayyagari, M., and Beck, T. (2015) reveal that the positive beneficial impacts of financial inclusion are reflected in promoting savings (Aportela 1999; Ashraf, Karlan, and Yin 2006), productive investment (Dupas and Robinson 2013), consumption (Dupas and Robinson 2013), and female empowerment (Ashraf, Karlan, and Yin 2010). Leading researchers such as Banerjee and Newman (1993), Galor and Zeira (1993), Aghion and Bolton (1997), Beck, Demirguc-Kunt, and Levine (2007) have shown that lack of access to finance leads people to poverty traps and inequality. Demirguc-Kunt and Klapper (2013) reveals that poor people are forced to rely on their own resources to meet their financial needs and face systemic or idiosyncratic shocks. The proponents of conventional financial inclusion argue that ensuring broad access to financial services under inclusive financial systems can benefit the poor people.

Financial inclusion is often considered as a critical element that makes growth inclusive as access to finance can enable economic agents to make longer-term consumption and investment decisions, participate in productive activities, and cope with unexpected short-term shocks. Growing theoretical and empirical evidence suggests that financial systems that serve low-income people promote pro-poor growth Alfred (Hannig and Stefan Jansen, 2010). Lack of access to finance, therefore, adversely affects growth and poverty alleviation. It makes it more difficult for the poor to accumulate savings and build assets to protect against risks, as well as to invest in income-generating projects. As a result, the interest in financial sector development has increasingly focused on the factors that determine not only the depth but also breadth of access, in a move toward inclusive financial systems. Understanding the link between financial inclusion, poverty, and income inequality at the country becomes vital for designing and implementing programs that broadens access to financial services, leading to reduction of poverty incidence and income equality (Cyn-Young Park and Rogelio V. Mercado, Jr., 2015).

5.3 The Concept of Financial inclusion in Islam and Its Status in Muslim World

The concept of financial inclusion in Islam is well integrated in the core objectives of Islamic Shariah known as 'Maqasid al-Shariah' which focuses on promoting welfare of each member of the community. In an Islamic society, a level playing field, including access to the natural resources provided by Allah needs to be ensured for all members

of the community so that every member can enjoy the opportunities and rights to groom themselves. In a fact, Islam emphasizes financial inclusion with social inclusion by meeting minimum requirements for a dignified life of each and every member of the society. The two distinct features of Islamic finance—the notions of risk sharing and redistribution of wealth—differentiate its path of development significantly from the conventional financial model (Iqbal, Z. and Mirakhor, A., 2012 and Iqbal, Z., 2015). The risk sharing and redistribution of wealth aspect builds the foundation of financial inclusion in Islamic that includes every member of the community including the under-privileged poor people. The only profit motive works as driving force behind conventional financial system that cannot include the poor segment of the society while both profit and welfare motives act as the motivating forces behind Islamic finance in which inclusion of the poor people has been made mandatory in principle and action.

Although financial exclusion is a serious problem for all developing countries, it is especially severe in Muslim-majority countries with around 700 million poor people who live on less than $2 per day (World Bank, 2014). The low level of financial inclusion among Muslims is explained by either factors of voluntary exclusion (such as religious considerations) or those of involuntary exclusion (such as discrimination, lack of financial literacy, lack of collateral, etc.). One major reason relating to voluntarily exclusion of many Muslim-headed households and firms from formal financial markets lies in absence of Shariah based financial services as Islamic Shariah prohibit predefined interest bearing loans. As a result, most conventional financial services are not relevant for religiously minded Muslim individuals and firms in need of financing. This is why only about 25 percent of adults in OIC member countries have an account in formal financial institutions, which is below the global average of about 50 percent (World Bank, 2014).

5.4 Tools of Financial inclusion in Islam

Both collateral based conventional banking system and collateral free microfinance have been failed to provide necessary financial services to unbanked poor people in Muslim majority countries. The conventional banking system does not offer financial services to poor people due to lack of collateral and high cost associated with credit assessment, monitoring and enforcement of law in case of default. Though the conventional microfinance has some economic and social impacts on the lives of millions of the poor, it could not prove suitable and effective for all the poor, hardcore poor in particular because of high rate of interest, lack of product diversity, paucity of adequate funds and absence of private sector participation (Iqbal, Z, 2015). Based on the notions of redistribution of

wealth and risk sharing embedded in Islamic Shariah, Islamic microfinance may be an effective tool in promoting financial inclusion towards poverty alleviation in developing poor OIC countries. Islamic microfinance can employ either 'redistribution of wealth tool' or 'risk sharing tool'or both in combating poverty. The application of financing tools depends on the level of poverty as shown in table 5.1.

Table 5.1: Tools for Financial Inclusion under Islamic Microfinance

Level of Poverty	Name of Tool	
	Redistribution Tool	Risk sharing Tool
Extreme Poverty (Below poverty line)	Charity based microfinance model (Zakat, sadaqa and waqf based)	Collective risk sharing through collective support during crisis
Poverty (Above poverty line)	Charity based microfinance model (Zakat, waqf and qard hasana based)	Profit based Microfinance model (Mudaraba, Musharakah) with micro-Takaful
Low income*	Charity based microfinance model (waqf and qard hasana based).	Profit based Microfinance model (Mudaraba, Musharakah) with micro-Takaful

Source: Adopted from Iqbal Z (2015). * If needed, other Islamic financing tools such as murabaha, muajjal, istisna, salam and ijara may be used in promoting income.

Iqbal Z (2015) opines that the tool of redistribution of wealth is based on redeeming the rights of the poor in the income and wealth of the rich. Islam's redistributive instruments include set of mechanisms comprising either mandatory levies (zakat), or philanthropic contributions (sadaqat and waqf, or benevolent loans, qard al-hassana). Islam has made zakat compulsory and encouraged charities for ensuring welfare of the poor who lack basic needs for survival and financial support for engaging in economic activities. In contrast, the risk sharing tool consists of the core principle of risk sharing, which is promoted through permitted contractual agreement for undertaking business transactions as well as through the concept of risk sharing with less fortunate members of the society through self help and exhibition of solidarity during difficult and unexpected times of economic distress. To promote financial inclusion among poor, the two tools can be used separately or jointly depending on the poverty level of different segments of society who suffers from financial exclusion.

The tool of redistribution of wealth, built-in in Islamic values can play as a powerful tool for promoting financial inclusion among the extreme poor to help them getting out rid of poverty cycle. By using this tool, funds collected under zakat and sadaqa are provided to the extreme poor for availing basic necessities of life. Besides, caring Muslims can help extreme poor and destitute people and share risks with more voluntary donations during an economic shock or a natural disaster going beyond the minimum

prescribed contribution. In order to enable them to be economically active, vocational training and skill enhancement services may be offered through waqf. Following these actions, extreme poor would become eligible to break poverty line.

Both redistribution and risk sharing tools need to use for reduction of poverty above poverty line. Funds collected under zakat and sadaqa may be used for consumption purpose while qard hasana can be extended for investment purposes. Training for skill enhancement may be provided using waqf. Deserving poor may avail finance under profit based microfinance model (using either mudaraba or musharaka instrument with micro-takaful). Following these actions, poor above poverty line would become low income poor.

Low income poor may apply either redistribution or risk sharing tool or both according to their requirements. Funds collected under qard hasana may be used for investment purpose while training for skill enhancement can be extended through waqf. Either mudaraba or musharaka instrument with micro-takaful under profit based microfinance model may be undertaken in generating microenterprises for promoting sustainable income. If needed, other Islamic financing tools such as murabaha, muajjal, istisna, salam and ijara may be used in enhancing income generating activities.

As conventional microfinance has failed to tackle all types of poverty, extreme poverty in particular, Islamic microfinance programs based on the principles of risk sharing and redistribution of wealth may be used as an effective tool for eradication of poverty and inequality in the society. The unique models of Islamic microfinance can help all types of poor to lift them out of poverty cycle and promote financial and social inclusion for building an egalitarian and peaceful society.

6. Current Status and Potentials of Islamic microfinance in Bangladesh

6.1 Current Status of Islamic microfinance in Bangladesh

Bangladesh has a small size of Islamic microfinance market comprising 4 Islamic banks, 20 small Islamic microfinance institutions (IMFs) and Islamic microfinance program of a conventional MFI (Table 6.1). Association of Muslim Welfare Agencies in Bangladesh (AMWAB) works as a wholesale fund provider to a limited scale. Islamic banks are mandated from Bangladesh Bank, Central Bank of Bangladesh while Islamic microfinance institutions (IMFs) have licenses from Micro Credit Regulatory Authority (MRA), the watchdog of microfinance in Bangladesh. Islami Bank Bangladesh Limited (IBBL), the first Islamic bank in South Asia is the largest

provider of Islamic microfinance in Bangladesh accounting for 78.84 percent share of Islamic microfinance market.

Table 6.1: Status of Islamic Microfinance in Bangladesh (2015)

Provider of Islamic MF	Number of Clients (Million)	Yearly Loan Disbursement (BDT in billion)	Outstanding of Loan (BDT in billion)
1. Islami Bank Bangladesh Limited	0.947	29.92	20.80
2. Al Arafah Islamic Bank Limited	0.050	3.52	0.66
3. First Security Islam Bank Limited	0.004	0.10	0.08
4. Social Islamic Bank Limited	0.0007	0.01	0.01
5. Islamic NGOs/MFIs (20)*	0.220	4.17	2.77
6. Conventional NGO with Islamic Microfinance (1)*	0.005	0.23	0.03
Total	1.70	37.95	24.36

Source: (i) Respective Islamic banks, (ii) Association of Muslim Welfare Associations Bangladesh (AMWAB) and (iii) TMSS- Only conventional NGO with Islamic microfinance program. * Provisional data

IBBL operates Islamic microfinance programs under Rural Development Scheme (RDS) in Bangladesh since 1995 with great success replicating Grameen Bank model. RDS is treated as first Islamic Microfinance Model in the country & abroad. IBBL accounts for in Bangladesh. Currently, the annual loan disbursement of RDS of IBBL stood at 29.92 billion and the number of clients was 0.947 million in 2015. Among small microfinance institutions, one foreign NGO namely Muslim Aid provides microfinance among the poor.

6.2 Islamic Microfinance: A Small Share of Microfinance Market

Though Islami Bank Bangladesh Limited (IBBL) and other institutions are running successful Islamic Microfinance programs, Islamic microfinance industry as a whole is lagging far behind compared to conventional microfinance industry in terms of number of clients, amount of financing, amount of saving mobilization and number of institutions offering micro financial services. The number of clients of Islamic microfinance stood at 1.70 million in 2015 which is much lower as compared to 37.04 million of conventional microfinance (Table-6.2). Similarly, the amount of disbursement of Islamic microfinance stood at BDT 37.95 billion in 2015 as compared to BDT 829.16 billion of conventional microfinance. The number of institutions that provides Islamic microfinance is also few as compared to those of conventional

microfinance providing institutions. Islamic microfinance is offered in Bangladesh by 4 Islamic Banks, 20 NGOs and one conventional MFI. To the contrary, Grameen bank, 693 microfinance instructions (MFIs), 14 commercial and specialised banks and different ministries offer conventional microfinance.

Table 6.2: Status of Conventional Microfinance in Bangladesh (2015)

Providers of Conventional MF	Number of Clients (In million)	Loan Disbursement (BDT in billion)	Outstanding of Loan (BDT in billion)
1. Grameen Bank	8.80	138.90	91.29
2. NGOs/MFI (693)	26.00	634.00	352.41
3. State Commercial and Specialized Banks (8)	0.85	25.53	10.76
4. Private Commercial Banks (6)	0.25	8.13	2.89
5. Different Government Ministries/Agencies	1.14	22.60	19.71
Total	37.04	829.16	477.06

Source: Resume of Banks, Insurance and Financial Institutions, 2015-2016, Ministry of Finance, Government of Bangladesh.

Clearly, Islamic microfinance accounts for only 3-5 percent of the entire microfinance market in Bangladesh despite Muslim majority people and success of Islamic banking. The small share of Islamic microfinance is depicted in Chart 1 and Chart 2.

Chart 1: Share of Clients of Islamic Microfinance (2015)

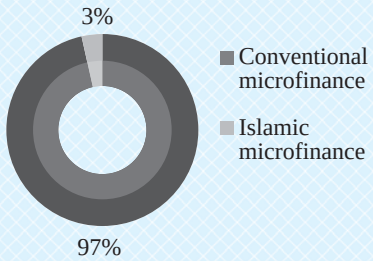
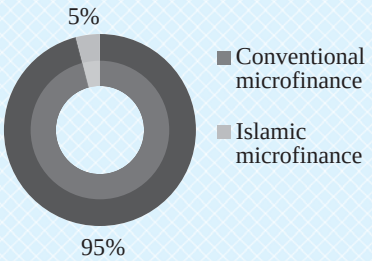


Chart 2: Share of disbursment of Islamic Microfinance (2015)



The key factors that contribute to explosive growth of conventional microfinance in Bangladesh include visionary leadership in microcredit movement, a group of dedicated professionals, group lending model, huge population, liberal policy supports from successive governments, investment in rural infrastructures, and generous assistance from development partners (Hulme, D. and Moore, K., 2007). Islamic Microfinance in Bangladesh did not grow like conventional microfinance due to lack of visionary

leadership, negative attitudes of a section of conservative religious leaders, want of adequate motivation from top management of Islamic banks, lack of directions/ guidelines from regulatory authorities, paucity of suitable instruments, inadequate funds, lack of proper use of zakat funds and want of dedicated trained professionals.

6.3 Islamic Microfinance in Bangladesh: Potentials and Significance

Despite low share of Islamic Microfinance, it has great growth potentials to flourish in Bangladesh. The following factors may be explained for bright prospects and significance of Islamic Microfinance in Bangladesh.

Promoting Financial Inclusion of Religious People- Islamic microfinance has great potentials to expand in Bangladesh traditional microfinance program has failed to bring all the poor people under its network. As traditional microfinance is interest based and interest is prohibited in Islam, many religious people are reluctant to use it for income generating activities resulting financial exclusion. This implies that Islamic microfinance may emerge as a potent driver of financial inclusion among poor people, hardcore poor in particular in Bangladesh. This is significant in attaining inclusive growth and poverty allegation in Bangladesh. A report on Bangladesh by UNDP (2012) quotes rightly-- "With a large number of poor women and men, unable to access financial services due to religious restrictions and beliefs, it becomes important for governments, the private sector, especially Islamic commercial banks among other stake holders, to support Islamic MFIs and channel resources to service those who need it most, poor women and men, girls and boys. Islamic microfinance has a positive role in poverty alleviation with huge untapped potential as an effective socioeconomic development tool".

Microfinance programs based on commercial motive with high interest rate have failed to reach the hardcore poor. As invisible hands of market economy cannot remove their hardships, they need unique program- cash with zero interest rate with other supports beyond funds which includes food relief, training and health facilities. Given this, Islamic microfinance may emerge as a viable panacea to solve the problems of hardcore poor employing its charity based model.

Success of Islamic banking: Bangladesh is one of the star performers in Islamic banking among Muslim majority countries of the world. In Bangladesh, currently out of 56 commercial banks, 8 private sector banks (PCBs) having 965 branches have been functioning as full-fledged Islamic Banks and 20 branches of 9 conventional banks and 25 windows of 7 conventional banks are also offering Islamic banking services. Total deposits and investment of the Islamic banking account for more than twenty one

percent of the total banking system at the end of December, 2015 (Bangladesh Bank, 2015). The Islamic banking industry has now more than 10 million account holders in Bangladesh indicating a wide acceptance for Islamic financing in Bangladesh. Clearly, ground has been prepared emergence for Islamic microfinance as an important financing tool in poverty alleviation program.

Excess liquidity of Islamic banks: Bangladeshi Islamic banks have excess liquidity due to non-availability of suitable investment instrument. At the end of December 2015 quarter, surplus liquidity of Islamic banks stood at BDT 131.16 billion (Bangladesh Bank, 2015). Islamic microfinance may be a viable instrument for Islamic banks to invest some part of excess liquidity of Islamic banks. This will also ensure the achievement of welfare objective of Islamic bank which is a core part of Islamic banking as per Shariah, the guiding principle of Islamic banking.

Success of Islamic Micro Finance Programs of IBBL: The RDS program of IBBL is a great testimony that Islamic microfinance programs can be expanded in Bangladesh successfully.

Promoting micro and small enterprises: Bangladesh needs to promote micro and small enterprises massively to absorb million of youth. In this regard, the role of conventional microfinance is not satisfactory mainly due to high rate of interest. Islamic microfinance may easily fill the gap with its unique models.

Experience of Conventional Microfinance**:** The experience of big MFIs like Grameen bank, BRAC, ASA and other top NGOs may be crucial in expanding Islamic microfinance.

Potential Zakat fund: Bangladesh has Zakat Board under Islamic Foundation managed by Government and other few social organizations for collecting zakat and distributing those among the poor people. But their performance is far below than great potentials. Developing proper mechanism may enhance collection of Zakat that may play vital roles in developing charity based Islamic microfinance model toward poverty alleviation.

Presence of many waqf estates: Waqf, as a religious charitable institution has been in existence in Bangladesh for centuries in order to attain various types of religious, educational and social welfare purposes (Karim, M.F., 2009). According to the Census of Waqfs, 1986 out of 150,593 waqf estates in the country, only 97,046 are registered, 45,607 are verbal and the rest 7,940 are waqf by tradition. Besides pursuing religious

and philanthropic objectives, the income of the estates may be used for developing charity based Islamic microfinance model toward for socio-economic advancement of the poor.

Attracting foreign funds: Foreign funds particularly from Middle Eastern Muslim majority countries, Islamic Development Bank (IDB) and other international bodies may be attracted through proper designing of Islamic microfinance program.

Serving All Faiths, Muslim and non-Muslim: The beauty of Islamic microfinance lies in its capability to serve all faiths, Muslim and non-Muslim.

7.1 Challenges facing Islamic Microfinance

Despite huge potentials, the share of Islamic microfinance is only 3-5% of total microfinance market. The key challenges that Islamic microfinance industry faces include: (i) absence of Guidelines for Islamic Microfinance from Micro credit Regulatory authority (MRA); (ii) want of motivation from Islamic Bank management; (iii) absence of adequate Islamic Microfinance Institutions; (iv) want of suitable instruments and (v) paucity of trained human resources.

7.2. Policy Options and Conclusion

It is imperative to adopt following policy options to promote Islamic microfinance industry in Bangladesh.

- *Issue of guidelines on Islamic Microfinance Institutions by Micro credit Regulatory authority (MRA) covering all operating aspects including capital adequacy, risk management, auditing and monitoring, and global financial reporting standards.*
- *Allowing a good number of Islamic Microfinance Institutions (IMFIs) by MRA, establishing separate Department at MRA for supervising Islamic Microfinance Institutions and Shariah Advisory Board for ensuring Shariah compliances.*
- *Adopting financial engineering for product diversification in order to meet demands of all categories of poor*
- *Undertaking proper steps for credit, liquidity and market risk management for ensuring sustainability of Islamic Microfinance*
- *Creation of central data base on Islamic Microfinance for avoiding over-indebtedness*

- *Developing proper steps for ensuring smooth supply of funds from charity based sectors as well commercial sectors with more involvement of Islamic Banks.*
- *Arranging dialogue with conventional microfinance institutions to introduce Islamic microfinance for promoting financial inclusion among hardcore poor people*
- *Application of modern mobile phone and other technology to reduce operational cost and expand network in remote areas towards promoting financial inclusion among unbanked people.*
- *Adoption of programs for developing devoted and skilled human resources. More efforts should be made to train Islamic MFI managers and staff.*
- *Promoting research on IMF in order to build the capacity of players at the micro, meso and macro levels, to help develop and implement appropriate business models. This also needs to better understand the size and segments of demand, on one hand, and to try to come up with a group of products responding to this demand, on a large scale (Khaled, M., 2011).*

Higher GDP growth, near self sufficiency in food production, promotion of export-oriented labour intensive ready-made garments (RMG), manpower export and huge expansion of conventional microfinance contributed greatly to reduce poverty in Bangladesh. Despite significant progress in reducing poverty, 24.8 % people still live in poverty and 12.9 % people live in extreme poverty. Traditional microfinance failed to reach among all categories of poor, hardcore poor in particular due to higher rate of interest, lack of adequate fund and want of customized products. Given this, Islamic microfinance program may act as a viable tool in promoting financial inclusion and combating poverty through its inclusive and innovative models based on zakat, sadaka, waqf and commercial funds to cater the demand of all categories of poor. To this end, policy makers, academicians, practitioners, Islamic bankers and philanthropist should join hands to build an Islamic microfinance market in order to establish a caring society based on equity and justice.

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